

Office of Chief Counsel
Internal Revenue Service
memorandum

CC:TEGE:EOEG:ET1:LMDonis
POSTN-104564-09

date: April 2, 2009

to: Laird MacMillan
Senior Tax Analyst
Small Business/Self Employed
Specialty Programs
Employment Tax Program
Employment Tax Policy

from: Janine Cook
Branch Chief, Employment Tax Branch 1 (Exempt Organizations/Employment
Tax/Government Entities)
(Tax Exempt & Government Entities)

subject: Interest-free Adjustments in the Audit Context

You have asked us questions regarding the application of section 6205 and the accompanying regulations, as amended by TD 9405, in the audit context.

ISSUE

In audit situations, when is an interest-free adjustment available pursuant to section 6205 and the accompanying regulations recently amended by TD 9405?

FACTS

Situation 1: In the course of an employment tax audit, an erroneous underpayment is discovered on a return previously filed by Employer. Employer immediately agrees to the findings and signs Form 2504¹, *Agreement to Assessment and Collection of Additional Tax and Acceptance of Overassessment (Excise or Employment Tax)*, and pays the amount due with Form 2504.

Situation 2: The same facts exist as in situation (1), except Employer does not pay the amount due at the time Form 2504 is signed. Employer subsequently receives a notice and demand for payment and sends in a check for the amount due prior to the due date

¹ References to Form 2504 in this memorandum also include, where applicable, Form 2504-WC, *Agreement to Assessment and Collection of Additional Tax and Acceptance of Overassessment in Worker Classification Cases (Employment Tax)*.

of the return for the period in which the Form 2504 is signed while meeting with the examiner.

Situation 3: In the course of an employment tax audit, an erroneous underpayment is discovered on a return previously filed by Employer. Employer does not agree to the findings and does not sign Form 2504. Employer declines to exercise his appeal rights. Before the examining agent closes the case unagreed, Employer subsequently pays the amount due before the due date of the return for the return period in which Employer declines to exercise his appeal rights.

Situation 4: The same facts exist as in situation (3) except that the Employer does not pay the amount due before the examining agent closes the case unagreed. However, before notice and demand for payment is received, and before the due date of the return for the return period in which Employer declines to exercise his appeal rights, the Employer sends in (a) a signed Form 2504 or (b) a check for the amount due.

Situation 5: In the course of an employment tax audit, it is determined that Employer should have treated its workers as employees. Employer does not agree to the findings and does not sign Form 2504-WC, *Agreement to Assessment and Collection of Additional Tax and Acceptance of Overassessment in Worker Classification Cases (Employment Tax)*. Employer goes to Appeals but no agreement is reached. Employer does not pay and a Notice of Determination is issued. Employer files a petition with Tax Court.

LAW AND ANALYSIS

Section 6205(a)(1) provides that an employer who has paid less than the correct amount of tax under sections 3101, 3111, 3201, 3221, or 3402 with respect to any payment of wages or compensation shall make proper adjustments, with respect to both the tax and the amount to be deducted, without interest.

The regulations under section 6205 set forth the procedures for making interest-free adjustments for underpayment of employment taxes. On July 1, 2008, the IRS and Treasury Department published final regulations (TD 9405) in the Federal Register (73 FR 37371). In relevant part, TD 9405 modifies the process for making interest-free adjustments of underpayments of employment taxes under section 6205. TD 9405 is effective as of January 1, 2009 and applies to errors discovered on or after January 1, 2009.

Section 31.6205-1(a)(1) provides that an employer who has underreported and underpaid FICA tax, RRTA tax, or income tax required to be withheld under section 3402 shall correct the error through an interest-free adjustment. Section 31.6205-1(a)(3) provides that the correction shall be made on an adjusted return.

Section 31.6205-1(a)(7) provides that Form 2504 and Form 2504-WC, and such other forms as may be prescribed by the IRS, constitute adjusted returns.

Section 31.6205-1(a)(2) provides that no correction will be eligible for interest-free treatment if the failure to report relates to an issue that was raised in an examination of a prior period, or if the employer knowingly underreported its employment tax liability. Section 31.6205-1(a)(6)(i) further provides that no correction will be eligible for interest-free treatment after receipt of notice and demand for payment or after receipt of a Notice of Determination of Worker Classification (Notice of Determination) in connection with such underpayment.

Section 31.6205-1(a)(6)(ii) provides that prior to receipt of a Notice of Determination, a taxpayer may, in lieu of making a payment, make a cash bond deposit that would have the effect of stopping the accrual of any interest, but would not deprive the taxpayer of its right to receive a Notice of Determination and to petition the Tax Court under section 7436.

Section 31.6205-1(b)(2)(i) provides that if an error is ascertained after a return is filed, the employer shall adjust the underpayment of tax by reporting the additional amount due on an adjusted return. The adjusted return must be filed by the due date for filing the return for the return period in which the error is ascertained and within the period of limitations for assessment under section 6501. The amount of the underpayment adjusted in accordance with this section must be paid by the time the adjusted return is filed. If an adjustment is reported pursuant to this section, but the amount of the adjustment is not paid when due, interest accrues from that date.

Section 31.6205-1(a)(5) provides that an error is ascertained when the employer has sufficient knowledge of the error to be able to correct it.

Revenue Ruling 75-464, 1975-2 CB 474, provides that for purposes of section 6205, an error may be ascertained during an audit of the employer's tax returns. The revenue ruling further provides that an underpayment of employment taxes ascertained during an audit may be paid interest-free if the employer signs Form 2504, or pays the tax, provided payment is made before receiving notice and demand and the requirements of making an interest-free adjustment are met. Specifically, situation 3 of the revenue ruling states that where no agreement is reached at the appellate level but the taxpayer voluntarily pays the amount with the intention of subsequently filing a claim for refund so that his tax liability can be decided by the courts and payment is made prior to the issuance of notice and demand, the error is considered ascertained at the time of voluntary payment and no interest should be charged on the payment of tax, provided the employer has complied with the instructions contained in section 31.6205-1 of the regulations² for correcting the ascertained error.

² Rev. Rul. 75-464 basis its analysis on the regulations under section 6205 in effect at the time. Although the regulations have since been modified, the current final regulations (TD 9405) are in relevant part substantially the same as those in effect when Rev. Rul. 75-464 was published.

GCM 35900 (July 15, 1974), the technical advice memorandum upon which Rev. Rul. 75-464 was based, provides that, in an unagreed case, the point in time at which the employer has sufficient knowledge that an error has been made so that he can correct it occurs when the employer (1) ultimately signs Form 2504, (2) has exhausted all of its inservice appeal rights but still has not signed Form 2504 and no notice and demand has been received, or (3) when it voluntarily pays the additional tax without a statement of notice and demand, as, for example, when he makes a payment so he can carry the case to court. GCM 35900 further clarifies that at the point in time when any of these events occur, the employer, in order to take advantage of the interest-free adjustment provision of section 6205, must comply with the instructions contained in paragraphs (b) and (c) of section 31.6205-1³ of the regulations for correcting an ascertained error.

Situation 1: Because Form 2504 is treated as an adjusted return pursuant to section 31.6205-1(a)(7) and because Employer pays by the time the adjusted return, in this case Form 2504, is filed, the requirements of the regulations have been met. Therefore, Employer has made an interest-free adjustment.

Situation 2: Because Form 2504 is treated as an adjusted return pursuant to section 31.6205-1(a)(7), Employer has made an interest-free adjustment. However, because Employer did not pay by the time the adjusted return was filed, interest begins to accrue from the date the Form 2504 is signed while meeting with the examiner until payment is received in accordance with section 31.6205-1(b)(2)(i). The receipt of a notice and demand for payment does not negate the fact that Employer has already made an interest-free adjustment.

Situation 3: This is similar to situation 3 in Rev. Rul. 75-464 in that Employer pays before receiving notice and demand such that the error is ascertained at the time of voluntary payment. However, in order for the payment to receive interest-free treatment, Employer must comply with the requirements of section 31.6205-1 by reporting the underpayment on and filing an adjusted return by the due date of the return for the return period in which the voluntary payment is made.

Situation 4: (a) If Employer sends in a signed Form 2504 after the case is closed unagreed but prior to receipt of notice and demand and prior to the due date of the return for the return period in which the Employer declines to exercise his appeal rights, Employer has made an interest-free adjustment. However, because Employer does not pay by the time Form 2504 is filed, interest begins to run from that date until payment is made.

(b) Similar to situation 3 above and situation 3 of Rev. Rul. 75-464, because Employer sends in payment prior to receipt of notice and demand, Employer can make an


³ GCM 35900 basis its analysis on the regulations under section 6205 in effect at the time. Although the regulations have since been modified by TD 9405, the current final regulations are in relevant part substantially the same as those in effect when GCM 35900 was published.

interest-free adjustment if Employer meets the requirements of section 31.6205-1 and files an adjusted return prior to the due date of the return for the return period in which the Employer declines to exercise his appeal rights. The closing of the case by the examining agent is not relevant to the application of the regulations.

Situation 5: Because Employer did not sign Form 2504-WC, pay the amount due, or make a cash bond deposit pursuant to section 31.6205-1(a)(6)(ii) prior to receipt of Notice of Determination, Employer did not make an interest-free adjustment under section 6205.

Case Hazards

Situations 3 and 4(b) illustrate that the application of the regulations and Rev. Rul. 75-464 results in different outcomes depending on whether an employer chooses to sign Form 2504. The employer that signs Form 2504 has made an interest-free adjustment and is entitled to interest-free treatment up to that point, with interest accruing only thereafter if payment is not made by the time Form 2504 is signed. However, the employer that pays but does not sign Form 2504 must still file an adjusted return to receive interest-free treatment under the regulations.



Janine Cook
Branch Chief, Employment Tax Branch 1 (Exempt
Organizations/Employment Tax/Government
Entities)
(Tax Exempt & Government Entities)